

of accounting. The functional currency shall be used for the year of adoption (or election) and for all subsequent taxable years unless permission to change is granted, or considered to be granted under § 1.985-2 or 1.985-8, by the Commissioner.

(b) *Condition for changing functional currencies.* Generally, permission to change functional currencies shall not be granted unless significant changes in the facts and circumstances of the QBU's economic environment occur. If the determination of the functional currency of the QBU for purposes of United States generally accepted accounting principles (GAAP) is based on facts and circumstances substantially similar to those set forth in § 1.985-1(c)(2), then ordinarily the Commissioner will grant a taxpayer's request to change its functional currency (or the functional currency of its branch that is a QBU) to a new functional currency only if the taxpayer (or its QBU) also changes to the new functional currency for purposes of GAAP. However, permission to change will not necessarily be granted merely because the new functional currency will conform to the taxpayer's GAAP functional currency.

(c) *Relationship to certain other sections of the Code.* Nothing in this section shall be construed to override the provisions of any other sections of the Code of regulations that require the use of consistent accounting methods. Such provisions must be independently satisfied separate and apart from the identification of a functional currency. For instance, while separate geographical divisions of a taxpayer's trade or business may have different functional currencies, such geographical divisions may nevertheless be required to consistently use other methods of accounting.

[T.D. 8263, 54 FR 38661, Sept. 20, 1989, as amended by T.D. 8776, 63 FR 40368, July 29, 1998; T.D. 8927, Jan. 11, 2001]

§ 1.985-5 Adjustments required upon change in functional currency.

(a) *In general.* This section applies in the case of a QBU that changes from one functional currency (old functional currency) to another functional currency (new functional currency). A tax-

payer or QBU subject to the rules of this section shall make the adjustments set forth in the 3-step procedure described in paragraphs (b) through (e) of this section. The adjustments shall be made on the last day of the taxable year ending before the year of change as defined in § 1.481-1(a)(1). Gain or loss required to be recognized under paragraphs (b), (d)(2), and (e)(2) of this section is not subject to section 481 and, therefore, the full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change. Except as provided in § 1.985-6, a QBU with a functional currency for its first taxable year beginning in 1987 that is different from the currency in which it had kept its books and records for United States accounting and tax accounting purposes for its prior taxable year shall apply the principles of this § 1.985-5 for purposes of computing the relevant functional currency items, such as earnings and profits, basis of an asset, and amount of a liability, as of the first day of a taxpayer's first taxable year beginning in 1987. However, a QBU that changes to the dollar pursuant to § 1.985-1(b)(2) after 1987 shall apply § 1.985-7.

(b) *Step 1—Taking into account exchange gain or loss on certain section 988 transactions.* The QBU shall recognize or otherwise take into account for all purposes of the Code the amount of any unrealized exchange gain or loss attributable to a section 988 transaction (as defined in section 988(c)(1)(A), (B), and (C)) that, after applying section 988(d), is denominated in terms of or determined by reference to the new functional currency. The amount of such gain or loss shall be determined without regard to the limitations of section 988(b) (i.e., whether any gain or loss would be realized on the transaction as a whole). The character and source of such gain or loss shall be determined under section 988.

(c) *Step 2—Determining the new functional currency basis of property and the new functional currency amount of liabilities and any other relevant items.* The new functional currency adjusted basis of property and the new functional currency amount of liabilities and any

other relevant items (e.g., items described in section 988(c)(1)(B)(iii)) shall equal the product of the amount of the old functional currency adjusted basis or amount multiplied by the new functional currency/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change (spot rate).

(d) *Step 3A—Additional adjustments that are necessary when a branch changes functional currency—(1) Branch changing to a functional currency other than the taxpayer's functional currency—*

(i) *Rule.* If a QBU that is a branch of a taxpayer changes to a functional currency other than the taxpayer's functional currency, the branch shall make the adjustments set forth in either paragraph (d)(1)(ii) or (d)(1)(iii) of this section for purposes of section 987. See § 1.987-5(d) for rules for computing the branch's equity pool and basis pool.

(ii) *Where prior to the change the branch and taxpayer had different functional currencies.* If the branch and the taxpayer had different functional currencies prior to the change, the branch's new functional currency equity pool shall equal the product of the old functional currency amount of the equity pool multiplied by the spot rate. No adjustment to the basis pool is necessary.

(iii) *Where prior to the change the branch and taxpayer had the same functional currency.* If the branch and the taxpayer had the same functional currency prior to the change, the branch's basis pool shall equal the difference between the branch's total old functional currency basis of its assets and its total old functional currency amount of its liabilities. The branch's equity pool shall equal the product of the basis pool multiplied by the spot rate.

(2) *Branch changing to the taxpayer's functional currency.* If a branch changes its functional currency to the taxpayer's functional currency, the branch shall be treated as if it terminated on the last day of the taxable year ending before the year of change. In such a case, the taxpayer shall realize gain or loss attributable to the branch's equity pool under the principles of section 987.

(e) *Step 3B—Additional adjustments that are necessary when a taxpayer changes functional currency—(1) Cor-*

porations. The amount of a corporation's new functional currency earnings and profits and the amount of its new functional currency paid-in capital shall equal the product of the old functional currency amounts of such items multiplied by the spot rate. The foreign income taxes and accumulated profits or deficits in accumulated profits of a foreign corporation that were maintained in foreign currency for purposes of section 902 and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also shall be translated into the new functional currency at the spot rate.

(2) *Collateral consequences to a United States shareholder of a corporation changing to the United States dollar as its functional currency.* A United States shareholder (within the meaning of section 951(b) or section 953(c)(1)(A)) of a controlled foreign corporation (within the meaning of section 957 or section 953(c)(1)(B)) changing its functional currency to the dollar shall recognize foreign currency gain or loss computed under section 986(c) as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change. Such a shareholder shall also recognize gain or loss attributable to the corporation's paid-in capital to the same extent, if any, that such gain or loss would be recognized under the regulations under section 367(b) if the corporation was liquidated completely.

(3) *Taxpayers that are not corporations.* [Reserved]

(4) *Adjustments to a branch's accounts when a taxpayer changes functional currency—(i) Taxpayer changing to a functional currency other than the branch's functional currency.* If a taxpayer changes to a functional currency that differs from the functional currency of a branch of the taxpayer, the branch shall adjust its basis pool in the manner prescribed in paragraph (d)(1)(ii) of this section for adjusting the equity pool, if the taxpayer's old functional currency was different from the branch's functional currency. If the

taxpayer's old functional currency was the same as the branch's functional currency, the branch shall determine its equity pool and basis pool in the manner set forth in paragraph (d)(1)(iii) of this section for determining the basis pool and equity pool, respectively.

(ii) *Taxpayer changing to the same functional currency as the branch.* If a taxpayer changes to the same functional currency as a branch of the taxpayer, the taxpayer shall realize gain or loss as set forth in paragraph (d)(2) of this section.

(f) *Examples.* The provisions of this section are illustrated by the following examples.

Example 1. S, a calendar year foreign corporation, is wholly owned by domestic corporation P. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. The following shows how S must convert the items on its balance sheet from the LC to the FC.

	1:2	
	LC	FC
Assets:		
Cash on hand	40,000	80,000
Accounts Receivable	10,000	20,000
Inventory	100,000	200,000
100,000 FC Bond (100,000 LC historical basis)	150,000	100,000
Fixed assets:		
Property	200,000	400,000
Plant	500,000	1,000,000
Accumulated Depreciation	(200,000)	(400,000)
Equipment	1,000,000	2,000,000
Accumulated Depreciation	(400,000)	(800,000)
Total Assets	1,300,000	2,600,000
Liabilities:		
Accounts Payable	50,000	100,000
Long-term Liabilities	400,000	800,000
Paid-in-Capital	800,000	1,600,000
Retained Earnings	² 50,000	100,000
Total Liabilities and Equity	1,300,000	2,600,000

¹ Under § 1.985-5(b), S will recognize a 50,000 LC loss (100,000 LC basis - 50,000 LC value) on the bond resulting from the change in functional currency. Thus, immediately before the change, S's basis in the FC bond (taking into account the loss) is 50,000 LC.

² The amount of S's LC retained earnings reflects the 50,000 LC loss on the bond.

Example 2. P, a domestic corporation, operates a foreign branch, S. The Commissioner granted permission to change S's functional currency from the LC to the FC beginning January 1, 1993. As of December 31, 1992, S's

equity pool was 2,000 LC and its basis pool was \$4,000. The LC/FC exchange rate on December 31, 1992 is 1 LC/2 FC. On January 1, 1993, the new functional currency amount of S's equity pool is 4,000 FC. The basis pool is not affected.

[T.D. 8464, 58 FR 233, Jan. 5, 1993; 58 FR 11099, Feb. 23, 1993, as amended by T.D. 8765, 63 FR 10774, Mar. 5, 1998]

§ 1.985-6 Transition rules for a QBU that uses the dollar approximate separate transactions method for its first taxable year beginning in 1987.

(a) *In general.* This section sets forth transition rules for a QBU that used the dollar approximate separate transactions method of accounting set forth in § 1.985-3 or § 1.985-3T (as contained in the April 1, 1989 edition of 26 CFR part 1 (1.908 to 1.1000)) for its first taxable year beginning in 1987 (DASTM QBU). A DASTM QBU must determine the dollar and hyperinflationary currency basis of its assets and the dollar and hyperinflationary currency amount of its liabilities that were acquired or incurred in taxable years beginning before January 1, 1987. In addition, a DASTM QBU must determine its net worth, including its retained earnings, at the end of the QBU's last taxable year beginning before January 1, 1987. This section provides rules for controlled foreign corporations (as defined in section 957 or section 953(c)(1)(B)), other foreign corporations, and branches of United States persons that must make these determinations.

(b) *Certain controlled foreign corporations.* If a DASTM QBU was a controlled foreign corporation for its last taxable year beginning before January 1, 1987, and it had a significant event as described in § 1.964-1(c)(6) in a taxable year beginning before January 1, 1987, then the rules of this paragraph (b) shall apply.

(1) *Basis in assets and amount of liabilities.* The hyperinflationary currency adjusted basis of the QBU's assets and the hyperinflationary currency amount of the QBU's liabilities acquired or incurred by the QBU in a taxable year beginning before January 1, 1987, shall be the basis or the amount as determined under § 1.964-1(e) prior to translation under § 1.964-1(e)(4). The dollar adjusted basis of such assets and the dollar